HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows **Volume 47** **April 2011**

In January we had predicted that 2011 would be a good year for equities. Thus, we were pleased to see the U.S. stock market have its best first quarter in 12 years. Investors stayed essentially bullish despite the turmoil in North Africa and the Middle East, and the Japanese earthquake.

Interestingly, however -- and disturbing to us -- our outlook has shifted to something less confident and more troubled. We are struck by the heightened acknowledgement by financial and political leaders that the federal deficit is unsustainable and hugely destabilizing -- not just in future years -- but for the period immediately ahead. The "music" seems to be ending faster than anticipated.

One key event for us was the decision by the mutual fund company PIMCO, the nation's largest bond investor, to shed its holdings in U.S. government debt. PIMCO's long-time leader, William Gross, has become a strong voice of alarm over the federal deficit. In early April he wrote: " The U.S. will likely default on its debt, not in conventional ways, but via inflation, currency devaluation, and low-to-negative real interest rates."

Gross bases his prediction on deep skepticism that Washington politicians, despite recognizing the problem, will be able to find consensus on a viable solution. The philosophical differences between the Republicans and Democrats are too deep and intractable. He foresees stalemate and gridlock.

For the moment, many stock investors are shrugging off the Gross thesis. They expect financial markets to move ahead based upon gradual economic improvement and strong corporate earnings. At Hudson Advisors, we believe that Gross, sadly, is more correct than wrong. We think the specter of an unresolved federal deficit creates a huge drag on the economy and markets. Thus, our strategy going forward in 2011 is cautious and defensive.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first quarter of 2011. The stock market showed some volatility as the result of international events, but recovered with a strong performance for the quarter. The bond market was a mixed story, with corporate bonds continuing their rally and Treasury bonds showing a slight decline.

Equity Markets: Stocks moved ahead strongly in January and February based upon the perception of a recovering economy, strong corporate profitability, and continued low interest rates. Then, the twin shocks of the "Arab spring", and natural disaster and nuclear plant failure in Japan, caused a temporary stumble. But the market indexes recovered by the end of March, coming close to their February highpoints. Investors seemed willing to shrug off negative news out of desire to pursue attractive return.

The Dow Jones Industrial Average ended the quarter ahead 7.07% and the S&P 500 gained 5.92%. The Nasdaq Composite Index moved ahead 4.83% reflecting investor acceptance of risk, the strongest performer in the quarter was the Russell 2000 index of small company stocks, which grew 7.94%. The first half of April has seen modest slippage from the March 31 close. These more recent declines seem to reflect broader concerns -- which we share at Hudson Advisors -- rather than any particular event. The mood is shifting.

Fixed Income Markets: The corporate bond market was basically resilient in the first quarter. Corporate earnings and continued low interest rates seemed to overcome any longer-term concerns. According to the Barclays Capital index, investment-grade bonds rose 0.34% during the quarter. Meanwhile, U.S. Government bonds slipped moderately in price -- but also were resilient in the face of warning bells about spiraling U.S. debt. The yield on the 10-year Treasury ended the quarter at 3.4% versus 3.3% at the outset. (Bond prices and yields move in opposite directions.) This price decline seems modest in light of the long-term storm clouds that are gathering.

MAJOR MARKET INDEXES

	1 Q Total Return*
Dow Jones Industrials	7.07
S&P 500 Index	5.92
Russell 2000 Index	7.94
NASDAQ Index	4.83
Barcap Intermdt. Govt./Credit	0.34
MSCI EAFE Index	2.67

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: The economy remains an uncertain story. Statistical improvements are being reported in employment, manufacturing, and consumer sentiment. As mentioned, many corporations have strong cash positions and the profit outlook is good. Nonetheless, the housing market remains in a slump. Because of the Mideast turmoil, oil prices have spiked markedly in recent weeks – setting the stage for more broad-based inflation. Further uncertainty is created by the likelihood that the Federal Reserve may start tightening money in the second half of the year.

Then, there is also the William Gross scenario about the impact of uncontrolled federal deficits. Failure to reach political consensus could have quick and sharp consequences: rising inflation, a weak dollar, and unproductively low real interest rates. We certainly do not see the economy returning to recession. But we see the nation soon reaching the point where federal policies become a chokehold rather than a stimulus to economic growth. Restraint on federal borrowing is essential for a sustainable economic recovery.

The Market: The scenario described above will hurt equity performance. To a great extent, the market gains of the first quarter already reflect whatever good economic news exists. Looking forward, the stock market will be increasingly sensitive to the prospect of an economy distorted and burdened with too much federal debt.

We are not too doomsday with this viewpoint. We do not foresee a major retreat in the market. Fortunately, because of corporate earnings, equity valuations are still relatively low compared to historic norms. This situation gives considerable support to the current levels of the market indexes. But we do not see much upside potential for the remainder of 2011. We think it quite likely the market will remain in a narrow trading in the coming months and may close the year at levels approximate to the current position.

OUR STRATEGIES

Asset Allocation: For clients investing new money, and who have a growth orientation, we recommend 60% allocation to equities. Because of our caution on bonds, most of the remaining 40% would be in cash.

Preferred Equities: As expressed our position is cautious and defensive. Our focus is on large cap companies with international presence, strong balance sheets, and healthy cash positions. As always, we like companies that pay attractive dividends. Our sector preferences include:

TECHNOLOGY: Most technology companies have next generation products in development and consumers seem highly willing to keep their personal computer and communications equipment up to date.

ENERGY: Despite ongoing political turmoil in the Middle East, the long-term imbalance between supply and demand creates profit benefit in production and exploration companies. This is true of the large, integrated energy companies and the specialized companies such as deep sea drillers.

CONSUMER STAPLES: Companies that provide the necessities of life are good dividend payers in the current market – and will gain value as the economy improves. We especially like international companies that benefit from the growing middle class in emerging countries.

Fixed Income: Our view on the risk to long maturity bonds prices is clear and consistently stated. Our heighted concern about the federal deficit only reinforces this viewpoint. The impact of inflation will hit the bond markets sooner and more heavily than the equity markets. We are keeping the non-equity portion of client portfolios in shorter-term bonds and cash.

Dow Jones U.S. Sectors
(Percent Change for One Year, Ending March 31, 2011)

Oil & Gas	**16.73%**	**Consumer Services**	**4.39%**
Basic Materials	**5.49%**	**Telecommunications**	**3.70%**
Industrials	**8.73%**	**Utilities**	**2.88%**
Consumer Goods	**2.52%**	**Financials**	**2.89%**
Health Care	**5.68%**	**Technology**	**3.25%**

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